

**DEPARTMENT OF STATE REVENUE**

**LETTER OF FINDINGS NUMBER: 01-0254  
Adjusted Gross and Supplemental Net Income Tax  
For The Years Ending 1995 through 1999**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**Adjusted Gross and SNIT – Unrelated Business Income**

**Authority:** IC 35-45-5-3; IC 6-2.5-5-25; IC 6-2.1-3-23; IC 6-3-2-3.1(a); IC 6-3-1-17(a); 45 IAC 3.1-1-68; IC 35-45-5-3.

The taxpayer protests the imposition of adjusted gross and supplemental net income tax on proceeds from illegal gambling machines.

**Tax Administration – Penalty**

**Authority:** IC 6-8.1-10-2.1; 45 IAC 15-11-1 & 2

The taxpayer protests the Department's imposition of the ten percent (10%) negligence penalty.

**STATEMENT OF FACTS**

As a result of an income tax audit conducted by the Department of Revenue, illegal gambling machines were discovered at the taxpayer's location.

**Adjusted Gross and SNIT – Unrelated Business Income**

**DISCUSSION**

Under Indiana Code section 35-45-5-3 the machines operated in taxpayer's establishment constitute illegal gambling. Proceeds from illegal gambling are considered unrelated business income and subject to Indiana gross or adjusted gross and supplemental net income tax. Indiana State Police estimate that the amount of gross income from illegal gambling machines is approximately \$104,000 per year for a single machine. However, the Department chose to use the figures provided by the organization.

First, the taxpayer contends that the machines are not illegal and are used primarily in raising money for charitable purposes. At hearing, the taxpayer stated that the money raised from the machines helped supplement their bar operation. However, using any of the money to supplement their bar operation is not a charitable purpose. Second, taxpayer protests the imposition of gross, adjusted gross, and supplemental net income tax on proceeds from the machines. The taxpayer states that the proceeds from the machines, which was included on their federal return as exempt income, could be characterized as a casualty loss and therefore excluded from tax since the money at issue was allegedly stolen by a former member of the organization. Third, the taxpayer states that the amount of money attributable to the machines was significantly less according to their records. Finally, the taxpayer argues that their Quartermaster stole approximately \$109,000 during a period of one and a half years. This money includes income from the gambling machines.

IC 35-45-5-3 provides in pertinent part:

A person who knowingly or intentionally: ... (3) maintains, in a place accessible to the public slot machines, one-ball machines or variants thereof... commits professional gambling, a Class D felony.

The Department determined that illegal gambling by the taxpayer was unrelated to taxpayer's exempt purpose. Exemption from tax for exempt organizations is tied to the gross income tax provisions with respect to exempt organizations. IC 6-2.5-5-25. As provided under IC 6-2.1-3-23, exempt organizations are not entitled to exemption from gross income received by a taxpayer that is derived from an unrelated trade or business, as defined in Section 513 of the Internal Revenue Code. Thus, the Department's determination was guided by I.R.C. § 513, which provides, in part, the following:

...The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Pursuant to IC 6-3-2-3.1(a) and IC 6-3-1-17(a), the Indiana General Assembly has expressly adopted the Code's tax treatment, with respect to Code section 501(c) organizations, for purposes of the Indiana adjusted gross and supplemental income tax analysis. Moreover, the Department's rule 45 IAC 3.1-1-68 defines an unrelated trade or business under the same guidelines as Code section 513, and the rule also subjects any unrelated business income to the Indiana taxes. Additionally, the rule cites taxpayers to Code sections 511 through 515 for guidance in determining whether income is subject to the taxes.

The taxpayer, in support of its protest, provided financial reports for the years ending 1997, 1998, and 1999. These records consist of financial statement compiled by Accounting Data Corporation. The financials allegedly show the following amounts for the gaming machines:

1997 / \$71,628; 1998 / \$97,453; and 1999 / \$30. The taxpayer's accountant stated in hearing, that the amounts received from the gaming machines was reported on their federal return as exempt income. The taxpayer states that they did report all the income they received and that they had only characterized it as exempt. In other words, they accounted for all income received and were not trying to deceive the Department.

The taxpayer also provided victim's statement filed April 13, 2001 in Vigo Superior Court. The Post Commander states under oath, "The biggest theft was from our machines, which he would empty at 1:00am to 2:00am when nobody was present in the building. Several hundred dollars went through those machines every day. He was the only one who had access to the machines or whose responsibility it was to take the money therefrom and put it in our account at the bank...." The amount of money attributable to the gambling machines in taxpayer's statement does not comport with the numbers provided by their accountant.

### **FINDING**

The taxpayer's protest is denied in part and sustained in part. The taxpayer's protest regarding the taxability of gaming proceeds is denied. The taxpayer's protest is denied as to the amount of income attributable to the illegal gambling machines. However, the Department will allow the casualty loss as a deduction in calculating unrelated adjusted gross income.

## **II. Tax Administration - Liability for 10% Negligence Penalty**

### **DISCUSSION**

The taxpayer protests the Department's imposition of the ten percent (10%) penalty assessment. Indiana Code section 6-8.1-10-2.1 requires a ten percent (10%) penalty to be imposed if the tax deficiency is due to the negligence of the taxpayer. Department regulation 45 IAC 15-11-2 provides guidance in determining if the taxpayer was negligent. 45 IAC 15-11-1(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is also to be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.

Subsection (d) of IC 6-8.1-10-2.1 allows the penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayer must show that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. . . ."

In this instance, the taxpayer has shown reasonable cause. The taxpayer has provided to the Department's satisfaction, sufficient justification for interpreting the code as it did.

### **FINDING**

The taxpayer's protest is sustained.